

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:NED:BOS:TL-N-8333-98

HPBonner

date: JUN 14 1999

to: District Director, New England District
Joanne Betts MacDonald, Case Manager

from: District Counsel, New England District, Boston

subject: Request for Technical Advice: Section 277 Carryback

[REDACTED]
Taxable Year Ended [REDACTED]
Earliest Statute Expiration: [REDACTED]

DISCLOSURE STATEMENT

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Issue Presented

Whether I.R.C. § 277 prevents the carryback of a net operating loss attributable to transactions with members of a membership organization, and requires such loss to be carried

forward to be used in future years to offset income from members' transactions.

Conclusion

I.R.C. § 277 applies in the subject case, prohibiting the carryback of losses attributable to transactions with the taxpayer's members and requiring that such losses be carried forward. However, the expenses attributable to nonmember transactions are allowable, subject to I.R.C. § 162. It is recommended that you carefully analyze the income and expenses of the taxpayer to ensure that the amount of the I.R.C. § 277 adjustment is not excessive.

Statement of Facts

A. Initial Formation as a Tax Exempt Organization

The taxpayer was incorporated in [REDACTED] as a not-for-profit organization without shares and subsequently was determined to qualify for tax exempt status under I.R.C. § 501(c)(6). The taxpayer was formed to [REDACTED]

The taxpayer initially considered itself a [REDACTED] for the [REDACTED]. ([REDACTED])

The taxpayer's members were [REDACTED] companies including [REDACTED], [REDACTED], and others. The taxpayer received membership dues commencing in [REDACTED] of \$ [REDACTED] or more per year from each member, or sponsor, eventually receiving over \$ [REDACTED] in membership dues. The taxpayer's by-laws permitted the taxpayer to offset future licensing fees due from its members against membership dues previously paid by the members. During the period [REDACTED] through [REDACTED], the taxpayer filed information returns on Forms 990 and paid no income tax.

B. Restructuring as a Nonexempt Organization

In [REDACTED], the taxpayer voluntarily advised the Internal Revenue Service that it no longer qualified as a tax exempt organization, and commenced filing as a corporation on Form 1120. As described by the taxpayer's representatives, "[REDACTED] decided that it would no longer emphasize the self-initiated development of the [REDACTED] that previously benefitted the [REDACTED] as a whole. Instead, [REDACTED] would now direct its activities toward coordinating the development of [REDACTED] in response to proposals

initiated by its member organizations. Development of that technology would be contracted out to [REDACTED]'s members, who would be entitled to earn royalties in connection with the technology they developed." ([REDACTED] letter, [REDACTED])

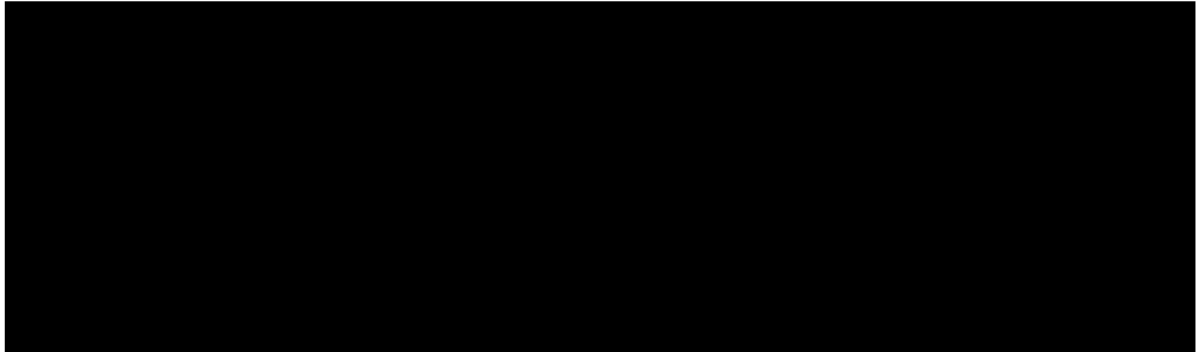
At the time the taxpayer became a nonexempt organization, it also admitted new sponsors. To prevent the new sponsors from unfairly reaping the benefits of the contributions of the original sponsors, the taxpayer voted to implement its "credit plan;" namely, allowing the original sponsors the option of exercising credits in the same amount as their contributions, against royalties and other licensing fees. This credit issue is the subject of TAM-[REDACTED], dated [REDACTED] which is now being circulated for comments by the [REDACTED] and the taxpayer.

C. Membership and Operations During [REDACTED] through [REDACTED]

During [REDACTED] through [REDACTED], the taxpayer had both voting and non-voting members. Voting rights were determined by the respective amounts contributed by the members. The Executive Sponsors, which were corporations contributing \$ [REDACTED] or more per year, were entitled to one vote each. The Allied Sponsors, which were groups of [REDACTED] associate sponsors who collectively reached the executive level of sponsorship, were entitled to one vote as a group. Other members, such as government agencies, non-profit organizations, and academic institutions, which paid annual dues ranging from \$ [REDACTED] to \$ [REDACTED] each, were not entitled to vote. The taxpayer was governed by a Board of Directors made up of representatives of each voting member.

The taxpayer advertised the benefits of membership as receipt of regular reports on updates; newsletters; participation in members meetings, workshops, and conferences; and a full range of activities and forums. In the "[REDACTED]" printed in [REDACTED] the taxpayer described the benefits of membership as follows:

[REDACTED]



D. Further Restructuring as a Stock Company

The taxpayer was further restructured in [REDACTED]-[REDACTED]. The taxpayer converged its business interests with a [REDACTED] company called [REDACTED] during [REDACTED], although both companies maintained their separate existences. Both the taxpayer and [REDACTED] became subsidiaries of [REDACTED] a Delaware limited liability company, in [REDACTED]. The taxpayer's directors authorized the issuance of stock and the elimination of the taxpayer's status as a membership organization in an Amended and Restated Certificate of Incorporation dated [REDACTED]. The taxpayer issued [REDACTED] shares of [REDACTED] stock and [REDACTED] shares of [REDACTED] stock at some time in [REDACTED]. The stock was issued as follows: [REDACTED] shares of [REDACTED] stock to [REDACTED] [REDACTED] shares of [REDACTED] stock to [REDACTED] and [REDACTED] share each of [REDACTED] stock to [REDACTED] and [REDACTED], [REDACTED] of the taxpayer's original sponsors. The taxpayer received consideration of \$[REDACTED] per share and a membership interest in [REDACTED]. The taxpayer remains in existence as a corporation, but is rapidly reducing its operations and downsizing its staff.

Analysis

I. I.R.C. § 277, Which Requires Deductions Incurred by Membership Organizations in Excess of Membership Income to be Carried Forward to the Succeeding Taxable Year, is Applicable to the Subject Case.

A. The Taxpayer Was a Nonexempt Membership Organization Throughout [REDACTED] the Year in Which the Net Operating Loss Arose

I.R.C. § 277(a) provides, in general, that in the case of a social club or other membership organization which is operated primarily to furnish goods to members and which is not exempt from taxation, deductions for the taxable year attributable to

furnishing services, insurance, goods, or other items of value to members shall be allowed only to the extent of income derived during such year from members or transactions with members (including income derived during such year from institutes and trade shows which are primarily for the education of members). If for any taxable year such deductions exceed such income, the excess shall be treated as a deduction attributable to furnishing services, insurance, goods, or other items of value to members paid or incurred in the succeeding taxable year.

I.R.C. § 456(e)(3) defines a membership organization as a corporation, association, federation, or other organization organized without capital stock of any kind, no part of the net earnings of which is distributable to any member. I.R.C. § 456(e)(3)(A), (B).

The taxpayer was a membership organization from its formation in [REDACTED] through [REDACTED]. The taxpayer voluntarily became a nonexempt organization in [REDACTED]. According to the Case Agent, the taxpayer operated as a membership organization throughout [REDACTED]. There is no indication that it attempted to be treated as a cooperative or other entity which would be excluded from I.R.C. § 277.

We have considered whether the approval of the issuance of stock on [REDACTED] removes the taxpayer from the application of I.R.C. § 277. It is our opinion that I.R.C. § 277 is still applicable, because the taxpayer operated as a membership organization for the entire taxable year [REDACTED].

B. The Taxpayer Was Operated Primarily to Furnish Services or Goods to Its Members in [REDACTED].

I.R.C. § 277 "denotes an objective test to determine whether a membership organization is operated primarily to furnish services or goods to its members. This standard refers to the manner in which petitioner operated and conducted its activities during the year in issue and entails a factual determination." Armour-Dial Men's Club, Inc. v. Commissioner, 77 T.C. 1 (1981), aff'd, 708 F.2d 1287 (7th Cir. 1983). The determination will be made based on the actual operations of the taxpayer, not its declared purpose. Associated Master Barbers and Beauticians on America, Inc. v. Commissioner, 69 T.C. 53 (1977) (declared purpose of taxpayer was to promote and elevate the standards of its profession, but actual operations were to provide insurance and other benefits to its members; therefore, § 277 was applicable); Armour-Dial Men's Club, Inc. v. Commissioner, 77 T.C. 1 (1981),

aff'd, 708 F.2d 1287 (7th Cir. 1983) (taxpayer's stated purpose was to promote better relationships among employees, but taxpayer primarily operated to provide goods and services to members at a reduced cost that were subsidized by the profits of a retail store it operated which sold consumer goods to the public at cost or below; § 277 applicable).

The I.R.C. § 277 analysis focuses on the activities of the taxpayer in the years at issue, not those of prior years, since a taxpayer's operations may change over time. The Synanon Church v. Commissioner, T.C. Memo. 1989-270. If a taxpayer has many activities, some of which are primarily to furnish services or goods to members, the Court will consider whether the taxpayer operated primarily for the benefit of the members, or whether member activities were incidental to the other operations. Id.

It appears from the information provided by you that the taxpayer operated primarily to furnish goods and services to its members in [REDACTED]. As set forth above, the taxpayer advertised the benefits of membership as including [REDACTED]

[REDACTED] The operations of the taxpayer appear to have been consistent with those advertised benefits, including the [REDACTED]

The taxpayer could argue that it was not operated primarily to furnish services or goods to members, because it was originally formed to [REDACTED]. However, it appears that the taxpayer's original purpose in fact changed over time, from benefitting the whole industry to furnishing services or goods to the specific members.

II. The Taxpayer May Be Entitled to Expenses Attributable to Transactions with Nonmembers.

Under I.R.C. § 277, a membership organization must determine both the respective amounts of its member and nonmember income, and the expenses attributable to member and nonmember income. In determining which expenses are attributable to the furnishing of services to members, courts will consider "whether such attribution is logical, reasonable, and rational; whether such attribution clearly reflects the income of the various activities of the membership organization; and whether such attribution is in accordance with generally accepted accounting principles."

The Boating Trade Association of Metropolitan Houston v. United States, 75-1 USTC ¶ 9398. Generally, the proper allocation of expenses under I.R.C. § 277(a) will depend on the facts and circumstances. Rev. Rul. 90-36, 1990-1 C.B. 59. Interest income earned on bank accounts held by the membership organization is considered nonmember income, and cannot be offset by membership expenses. Concord Consumers Housing Cooperative v. Commissioner, 89 T.C. 105 (1987). Profits from a business activity conducted by the membership organization are also considered nonmember income. Adirondack League Club v. Commissioner, 55 T.C. 796 (1971), aff'd per curiam, 458 F.2d 506 (2nd Cir. 1972).

The taxpayer had three major sources of funding during [REDACTED] through [REDACTED]: (1) sponsorship and membership fees; (2) licensing and royalty fees; and (3) fees for other services. According to the taxpayer's audited financial statements, the amounts and sources of the taxpayer's income in [REDACTED], [REDACTED], and [REDACTED] were as follows:

	[REDACTED]	[REDACTED]	[REDACTED]
Sponsor funding	\$ [REDACTED]	\$ [REDACTED]	\$ [REDACTED]
Membership fees	\$ [REDACTED]	\$ [REDACTED]	\$ [REDACTED]
License fees	\$ [REDACTED]	\$ [REDACTED]	\$ [REDACTED]
Other	\$ [REDACTED]	\$ [REDACTED]	\$ [REDACTED]
Total Revenue:	\$ [REDACTED]	\$ [REDACTED]	\$ [REDACTED]

The category "other income" included receipts from the [REDACTED] collaborative development projects, customer services, and other miscellaneous sources. The taxpayer also received interest income in the amounts of \$ [REDACTED], \$ [REDACTED] and \$ [REDACTED] respectively. The taxpayer did not make any allocation between member and nonmember income or member and nonmember expenses. The Case Agent considered all of the taxpayer's income to be member income except the interest income.

As set forth above, the taxpayer had two classes of members during [REDACTED], entities and groups of entities with voting rights and entities without voting rights. The members with voting rights were Executive Sponsors, which were corporations which contributed \$ [REDACTED] or more per year and which had one vote, and Allied Sponsors, which were groups of [REDACTED] associate sponsors that collectively reached the executive level of sponsorship and were entitled to one vote as a group. The members which had no voting rights were government agencies, non-profit organizations, and academic institutions which paid dues

of \$ [REDACTED] to \$ [REDACTED] per year and were not entitled to vote.

We recommend that you consider only the "members" of the taxpayer that had voting rights during [REDACTED] as members of the organization for the purpose of determining the amount of income and expense attributable to transactions with the taxpayer's members. Although we have found no direct precedent on this issue, the possession of voting rights and the resultant ability to control and direct the operations of an organization have been found by the courts to very important in determining who are the members of organizations. The Tax Court employed the following test to determine who were the members of a business league exempt from taxation under § 501(c)(6) in National Association of Life Underwriters, T.C. M. 379 (1992) at 338:

First, a member has specified rights and obligations in relation to an organization, including the right to participate in the organization's direction and the obligation to help support the organization through regular financial contributions. Secondly, all the facts and circumstances, including the organization's charter and bylaws, may be consulted in determining what those rights and obligations are. Finally, labels are not determinative; a person's status will determine that person will be considered a member of an organization.

See also, National Association of Postal Supervisors v. United States, 944 F.2d 859 (Fed. Cir. 1991) (dues paid by limited benefit members to an exempt organization were unrelated business income because limited benefit members were not bona fide members); American Postal Workers Union v. United States, 925 F.2d 480 (Fed. Cir. 1990) (dues from associate members were unrelated business income where associate members were entitled to insurance benefits but were not members in any other sense).

In view of our recommendation that you consider only the members of the taxpayer that had voting rights during [REDACTED] as members of the organization for the purpose of determining the amount of the organization's income and expense attributable to transactions with the taxpayer's members, it will be necessary for the case agent to separately determine the income derived by the taxpayer from members and from transactions with members from the income derived by the taxpayer from nonmembers.

The taxpayer incurred interest expense during [REDACTED] [REDACTED] and [REDACTED] in the amounts of \$ [REDACTED], \$ [REDACTED] and

\$ [REDACTED] respectively. The taxpayer incurred other expenses in the amounts of \$ [REDACTED] \$ [REDACTED] and \$ [REDACTED] respectively. Those expenses are referred to as total general and administrative expenses; no breakdown of such expenses has been provided.

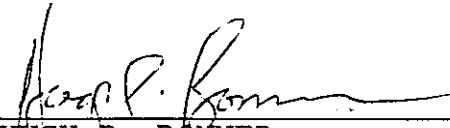
The Case Agent allowed interest expense as a deduction against interest income. The Case Agent calculated the ratio of interest income to total income for each year, and determined that nonmember income was approximately [REDACTED] percent of total income. Applying the [REDACTED] percent ratio to total expenses, and adding interest expense, the Case Agent determined that the taxpayer had allowable expenses against nonmember income in [REDACTED] of \$ [REDACTED]. As the taxpayer had claimed a net operating loss of \$ [REDACTED], the Case Agent proposed a \$ 277 adjustment in the amount of \$ [REDACTED].

The above-described methodology for calculating nonmember expenses appears reasonable, however you have not given the taxpayer credit for all of its nonmember income since the Case Agent has not considered dues, membership fees and other receipts from nonvoting members as nonmember income. In addition, the Case Agent states that he reviewed the books and records of the taxpayer, and without completing an invoice by invoice analysis, it appeared that the majority of the revenue is income from transactions with members, including dues and membership fees. It is possible that the taxpayer received other income from customers and nonvoting members (nonmembers) in addition to the dues and fees received from nonvoting members. If so, the ordinary and necessary business expenses attributable to such income would be allowable as current deductions in [REDACTED]. We therefore recommend that you review the taxpayer's books and records to determine accurate amounts of the taxpayer's nonmember income and expenses (including membership fees and dues received from nonvoting members), to ensure that the amount of the \$ 277 adjustment is not excessive.

Please contact the undersigned attorney if you have any questions on this matter.

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Assistant District Counsel

By:



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Attorney